

# WHAT FUTURE FOR THE INTERNATIONAL AND THE EUROPEAN MONETARY SYSTEMS?

By

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## *Introduction*

The process of globalisation affecting goods and financial markets together with the increase in capital mobility have led economists to reconsider the problem of exchange rates. The parallel increase in the number of countries opting for an extreme solution (currency boards, dollarisation and monetary unification on the one hand and free floating on the other) seems to suggest that both markets globalisation and capital mobility are better dealt with by exchange rate regimes allowing substantial exchange rate flexibility or adopting hard currency pegs. Recent analyses show, on the contrary, that ‘for many developing countries with less linkage to global capital markets, the viability and suitability of exchange rate pegs is greater’ (Mussa *et al* 2000: 2). Although economists continue to disagree about the reasons for exchange rate variations, there seems to be an even wider disagreement as to the need to consider a whole series of possible regimes each single country will have to opt for according to its peculiar situation.

At a recent meeting of the American Economic Association, Fischer delivered a lecture in which he presented the various options open to countries, the evolution in their choices during the past decade, and the tendency towards bi-polar or two-corner solutions. In particular, he maintains that ‘[i]t is reasonable to believe, as EMU expands, and as other economies reconsider the costs and benefits of maintaining a national currency [...] that more countries will adopt very hard pegs, and that there will in the future be fewer national currencies’ (Fischer 2001: 17). Our purpose here is to consider the ‘soft’ peg and the ‘hard’ peg solutions in order to show:

1. that each of them entails serious drawbacks for the countries implementing it; and
2. that the same desired result – exchange rate stability – may be reached by means of an alternative solution that preserves monetary sovereignty and does not require any intervention on the foreign exchange market.

Throughout the paper we take it for granted that exchange rate stability is to be preferred to free floating for the twofold reason that stability stimulates investment as well as trade and that exchange rate fluctuations are essentially erratic and of a speculative kind<sup>1</sup>. What we are claiming is therefore that countries should not be forced to choose between fixed or flexible

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exchange rates, but between the present structure of international payments and a reformed system ensuring exchange rate stability. In the present system, fixed exchange rates have a cost that exceeds their advantages and makes them not viable in the long term. What is needed at the international level is a system in which exchange rate stability becomes an automatic result of its current mechanism, without any need for countries to intervene on the foreign exchange market or to limit their monetary sovereignty. This may be achieved through a reform allowing for the vehicular use of the unit chosen as the international currency, and based on the principles of bank money and multilateral clearing. In the last part of the paper we give a brief numerical example of the way the new system may work. Very simple in its application, the reform may be implemented in steps, first by a group of countries of the same monetary area, for example, and then by the IMF world-wide.

As the euro is about to be adopted by the EU member countries<sup>2</sup> as their unique currency, let us pay particular attention to the pros and cons of European monetary unification. Capital accumulation and capital movements are phenomena that seem to have been underestimated by supporters of a single currency area. The loss of monetary sovereignty will have important effects on these phenomena, which will put the project of European unification under serious threat. It is therefore essential to investigate them and to tackle the question of whether or not it is necessary to give up monetary sovereignty in order to give Europe its own currency and a stable monetary system.

### *Soft pegged exchange rates*

Countries choosing to peg their currency to a 'strong' foreign currency or to a basket of currencies commit themselves to limit (or even reduce to zero as in the case of currency boards) the extent of fluctuation of exchange rates. Several possibilities are open to them, from managed floats to currency boards, passing through adjustable and crawling pegs, adjustable and crawling bands, and fixed pegs. In the case of soft pegged exchange rates, it has been claimed that they are not particularly well equipped to suit those countries highly involved with international capital markets. '*[S]oft peg systems have not proved viable over any lengthy period, especially for countries integrated or integrating into the international capital markets*' (Fischer 2001: 7). It is not difficult to understand, in fact, that pegged exchange rates of countries involved in capital markets are easily subjected to speculative pressures, which may be contrasted only through monetary policies that put a strain on their domestic economy as well as on their financial system. 'Countries that are not adequately prepared to withstand the potential strains of exchange rate defense should beware of slipping into exchange rate pegs that may later foster serious economic and financial crises' (Mussa *et al* 2000: 34).

In a regime of pegged exchange rates, monetary authorities must be prepared to intervene both on the foreign exchange market and on the financial market to defend the external stability

of their currency. This particular regime seems therefore to require a low involvement in the international capital market of the country implementing it, a flexibility of its fiscal policy and of its labour market, a close connection of its economy and of its financial system with those of the country with which it is pegged, and a high level of international reserves. IMF experts and economists are certainly right in observing that pegged exchange rates are not suited to emerging economies with strong links to global financial markets. Recent crises – the tequila, Asian, Russian and Brazilian crises – have shown that these economies are more subject than others to speculative pressures on their exchange rates, and that those which had pegged their currency suffered the most from the fluctuations on the capital markets. As noted by Fischer, '[i]n several countries, extensive damage has been caused by the collapses of pegged rate regimes that lasted for some time, and enjoyed some credibility. The belief that the exchange rate will not change removes the need to hedge, and reduces perceptions of the risk of borrowing in foreign currencies. This makes any crisis that does strike exceptionally damaging in its effects on banking systems, corporations, and government finances' (Fischer 2001: 7).

At this point a critical reader might ask whether there is any good reason to keep considering a system of soft-peg exchange rates as a viable regime at all. Most experts would answer that countries respecting the conditions listed above are likely to benefit from such a regime insofar as it would grant their currencies greater stability on the foreign exchange market. Others would plump for a free floating system, arguing that in the present system of international payments free exchange rate fluctuations are the best balancing mechanism available to countries. All would probably agree that solutions vary according to the country and the period of time considered. Now, while most of these observations are a matter of common sense, some of them rest on the assumption that exchange rates are bound to fluctuate more or less erratically unless a country commits itself to supporting the costs of a monetary policy capable of reducing the destabilising pressures on the foreign exchange market.

A rigorous analysis of the way the present system of international payments works shows that this is indeed the case today. In this respect, it is worth noting that experts such as Fischer, Mussa, Masson, Swoboda, Obstfeld, Eichengreen, Isard and many others tend to recognise that exchange rate fluctuations are mostly erratic and due to speculative capital movements more than to fundamentals. In a system where currencies are considered as if they were real goods, exchange rates are defined as their relative prices and their variation is directly influenced by supply and demand on the foreign exchange market. Attempts to reduce or control exchange rate fluctuations through a soft peg are therefore bound to failure in the medium or long term, since their cost can hardly be supported for long by any country, let alone by a developing country. While it is indisputable that exchange rate stability is to be preferred to erratic fluctuations, it seems hopeless to pursue this aim through a regime requiring national monetary authorities to contrast erratic fluctuations provoked by international speculative capital movements.

Even more so when referred to countries open to global financial markets, does this conclusion apply also when pegged exchange rates are replaced by currency boards or by dollarisation? Let us briefly analyse these two cases in succession.

### *Currency boards*

As shown by Fischer (2001), in the last ten years an increasing number of countries has opted for a system of hard peg known as ‘currency board’, in which the government is institutionally committed to converting its national money into a foreign currency (usually the US dollar) at a fixed exchange rate. Argentina is the emblematic example of this kind of exchange rate regime. The high level of inflation suffered by the peso led Argentina’s monetary authorities to enter a currency board in 1991.

The risks of using the exchange rate as a nominal anchor are usually identified with the fact that ‘interest rates become completely independent of the will of the domestic monetary authorities [because they] are closely linked to those of the anchor currency’ (Mussa *et al* 2000: 26). In a currency board regime, in fact, monetary policy is subordinated to the maintaining of fixed exchange rates and convertibility so that fluctuations in domestic interest rates ‘are determined by foreign exchange inflows and outflows’ (p. 25). On the other hand, benefits would derive from the exchange rate stability, an increased control over fiscal policy and the credibility of the economic policy regime.

While entering a currency board a country does not give up its monetary sovereignty, it is clear that its commitment to guarantee convertibility seriously reduces its autonomy. This may prove useful insofar as it forces the country’s monetary authorities to avoid inflationary over-emissions, but it might dangerously limit the process of capital accumulation within the country. The rigidity of the system is due to the fact that a currency board ‘must hold foreign reserves at least equal to its total monetary liabilities’ (p. 26), and that, in its pure form, it ‘cannot extend credit’ (p. 26). Hence, if it seems indisputable that modern currency boards have been successful in enhancing credibility of countries coming out of a period of high- or hyper-inflation, there is also evidence that ‘[e]ach of the major international capital market-related crises since 1994 [...] has in some way involved a fixed or pegged exchange rate regime’ (Fischer 2001: 1).

The arguments against currency board arrangements range from the claim that nominal exchange rate invariability slows down adjustment to external or internal shocks, to the claim that countries entering a currency board must give up their seigniorage as well as the lender of last resort function of their central banks. Let us consider, for example, the case in which Argentina has to face a substantial increase in the exchange rate of the US dollar as against most of the rest of the world’s currencies. As a consequence of this external shock, Argentina’s exports will decrease and its current account deficit increase. Fischer observes that an adjustment will have to take place through wage and price flexibility. But, while a decrease in wages is supposed to entail a decrease in prices capable to stimulate exports, Argentina’s population is likely to suffer from a substantial worsening of its standard of living. Paid for in US dollars, imported goods and services will in fact become the more expensive the greater the fall in wages entailed by the adjustment process. Of course, this negative effect would occur also if Argentina opted for a

flexible exchange rate regime. The US dollar appreciation would support Argentina's exports, but its imports would be more costly in terms of pesos. Yet, this simply shows that neither a currency board nor a flexible exchange rate system is a good solution. While the loss of seigniorage is a fallacy deriving from a poor understanding of modern banking<sup>3</sup> and the lender of last resort function of central banks can be 'compensated for by the creation [...] of a banking sector stabilization fund' (p. 16) and by other measures of supervision, control and collaboration, the strain put on the domestic economy of a country entering a currency board is a serious shortcoming calling for renewed efforts to find a viable solution to both currency boards and floating exchange rate regimes.

Even though currency board and flexible exchange rate regimes are likely to suffer from the same disadvantages due to a substantial increase in the US dollar exchange rate, the case against the hard-peg system is strengthened by the fact that a country implementing a currency board has no degree of freedom as to its monetary emission. The commitment to redeeming its monetary liabilities at a fixed exchange rate forces a currency board country to hold foreign reserves at least equal to its total domestic currency. In the case of Argentina, this implies that banks' monetary emission of pesos is limited by the amount of US dollar stocked within the Argentinean banking system. Needless to say, this dangerously limits the capacity of the banking system to respond to the demand for monetary intermediation coming from Argentina's productive sector. In other words, Argentina's productive capacity cannot expand beyond the limits posed by the availability of US dollars. Hence, if Argentina wants to increase its domestic output, it has to increase its reserves of US dollars, which it may do either by exporting more or by contracting a new external debt. In both cases, the growth in domestic production will cost Argentina twice its price. To the cost of production proper, Argentina will in fact have to add the cost of the goods, services and financial claims it sells in exchange for the US dollars required as guarantee to the monetary emission of its banks.

In order to gain credibility for its monetary policy, Argentina has chosen to peg its currency so hard as to lose, *de facto*, a great part of its monetary sovereignty. The price it has to pay does not seem to be balanced by the advantages it derives from exchange rate stability, so much so that the advantages could be obtained without being forced to transform its currency into a surrogate of the US dollar. Argentina's economic system needs to be backed by an autonomous banking system capable to monetise, without any arbitrary restriction, the whole of its productive activity. This cannot be the case under a currency board regime, whose advantages are therefore overwhelmingly overtaken by the restraints imposed to the economic activity of the countries that choose it.

Before moving on to consider the hardest variety of pegged exchange rates – i.e. dollarisation – let us observe that at a meeting held at the IMF, November 2000, Mundell openly declared to be in favour of currency board arrangements. According to the Nobel laureate, it might even be conceivable to introduce a currency board system at the world level, for '[a]fter all, that's what the gold standard was – it was what people nowadays call a currency board system' (Mundell *et*

*al* 2000: 17). Yet, Mundell seems to underestimate the fact that under the gold standard every country fixed the convertibility rate of its domestic currency with gold. Thus, gold was the common denominator that allowed national currencies to be made homogeneous before being exchanged one against the other. Expressed in terms of gold, exchange rates were determined on an absolute basis that gave them its own stability. In a currency board system, where currencies are convertible into the dollar, what would be the common denominator between them and the American currency? Gold is a real good, whereas the dollar is the US domestic currency, and it is an entirely different thing to anchor a currency to a real good or to another currency. Under the gold standard each currency had an absolute value and could be considered equivalent to any other of the same tenor. In a currency board system, national currencies would derive their value from the American IOU, since, outside the US, that is what the dollar actually is: a mere acknowledgement of debt issued by the US banking system. Hence, convertibility, which in the gold standard was a principle guaranteeing monetary homogeneity, would become, in a currency board system, an absurd obstacle to monetary sovereignty.

### *Dollarisation*

Some authors<sup>4</sup> have recently argued in favour of dollarisation, a process that has spread mainly in Central America, where Ecuador and El Salvador have just joined Panama in the group of countries that have replaced their domestic currency with the US dollar. The advantages of dollarisation as compared to currency board regimes are said to lie ‘in the reduction in spreads and the strengthening of the financial system’ (Fischer 2001: 16). The obvious difference between the two systems is that through dollarisation a country does away with its national currency. Exchange rate problems with the US currency are also definitively dealt with, of course. In fact, they are literally suppressed together with the suppression of domestic money. Identified with the US dollar, the currency of these countries floats jointly with the floating of the US currency. Now, the shortcomings related to currency board regimes become evident in the case of dollarisation. In particular, countries that choose this radical solution against their monetary instability must confine the credit activity of their banking systems to the amount of US dollar deposited with them. In contrast with what happens in the United States, these countries’ banks are not allowed to issue new dollars, either to monetise their domestic production or to pay for their country’s net commercial imports. What they can do is merely to lend the dollars they own as deposits. Of course, a central bank may increase its reserve of US dollars by incurring a new foreign debt. But this means that the countries that have dollarised their monetary systems must run into debt in order to be able to monetise their own production. Hence, either they cut production or they pay twice its new costs. In both cases the price of dollarisation is so high that it is hard to understand how it can be imposed on the population.

Things would be different if banks of ‘dollarised’ countries were allowed to issue their

own dollars. However, in this case only two scenarios may be envisaged. Either the US government could agree to accept these countries as new States of the Union, or it would force their banks to change the denomination of their currencies. The first scenario is not likely to draw much favour, and would have drastic consequences from the political and cultural points of view. The second solution would restore the situation existing before dollarisation, since it would bring out the substantial difference existing between the US dollar and the dollar used within other countries.

Economists seem to be aware of the consequences of dollarisation, even though they do not always have a clear perception of all of them. For example, Fischer claims that '[f]or a small economy, heavily dependent in its trade and capital account transactions on a particular large economy, it *may* well make sense to adopt the currency of that country, particularly if provision can be made for the transfer of seigniorage' (Fischer 2001: 17). Now, if it is true that such an economy should be allowed to issue the currency it needs in order to monetise its production (and it is in this sense that Fischer's use of the concept of seigniorage is interpreted), we should not forget to analyse the implications for the US monetary system. If the FED were not prepared to control the banking system of the 'dollarised' country and to include it in its clearing system, the dollars issued in that country would become a source of instability. In particular, if the central bank were to abuse its lender of last resort function (which still happens to a worrying extent in numerous LDCs), the inflationary increase of dollars would have negative consequences in all the dollar areas. Besides, the 'dollarised' country would be able to pay in newly issued dollars for its net purchases of goods and services. Thus, the amount of dollars held abroad would increase and define the net debt of the dollar area as a whole, independently of the geographical location of the banks carrying out the payments.

In conclusion, this extreme solution does not seem to be appropriate, either for the LDCs likely to adopt it, or for the United States. The loss of monetary sovereignty has a host of negative side-effects when it is unilateral. What happens instead when monetary sovereignty is given up simultaneously by a group of countries deciding to create a monetary union? The case of European monetary unification is by far the most important of all, and it is to its analysis that we are devoting the greater part of our study.

### *Currency unions*

Another solution to exchange rate instability implying the loss of monetary sovereignty is the creation of a currency union among independent countries. Although it is not the first case of monetary unification, the creation of a European monetary area is the most significant example of such a solution. Unlike what happens for the CFA zone, the European project will soon lead to the actual replacement of national currencies with an entirely new currency – the euro – and to the monetary birth of a new country – the United States of Europe. Of course, the introduction of the euro will remove any risk of exchange rate fluctuations among the twelve European currencies

replaced by the European currency. Abandoning monetary sovereignty, on the other hand, will require an increased macroeconomic co-ordination ranging from common monetary and fiscal policies to a greater integration of labour and commodity markets. Co-operation and regional solidarity will also prove essential in the process, and it is to be feared that this might prove to be more difficult to obtain than generally recognised. Worries come from the observation that the criteria for the successful implementation of a single currency area are not entirely satisfied by EU countries. It is no mystery that a whole variety of ‘public accounting fiddles’ (Dafflon and Rossi 1999: 63) have occurred during 1997, the year chosen to verify if countries complied with the convergence criteria imposed by the Maastricht Treaty. Things have not drastically improved since, and there are signs that disparities are far from heading towards reduction. In this context, one feels entitled to ask whether monetary unification is indeed going to benefit EU countries, in other words whether it is actually true that advantages far outweigh disadvantages.

In order to answer this question we have to consider the full implications of free capital mobility that the euro will make possible within the new European monetary area. As noted by Obstfeld ‘this [capital mobility] is a very relevant issue. Here, I think the question of whether capital mobility enhances the gains from a single currency or not depends very much on the type of capital flow that is being considered’ (Mundell *et al* 2000: 4). Let us dwell briefly on this matter.

The concept of capital flight has often been taken to mean – literally – that capitals may leave the country in which they originate to be ‘hidden’ or invested abroad. Now, while it is true that capitals may be illegally concealed from fiscal authorities by being transferred to a foreign banking system, it is mistaken to believe that by doing so they also escape their original banking system. If a resident of country *A* manages to hide his capital by transferring it to a foreign bank (of country *B*), he causes his national fiscal authorities a net loss; it is a fact. However, this does not entail an equivalent loss for his domestic banking system. Double-entry book-keeping prevents such loss. In reality, the entire amount ‘transferred’ abroad remains deposited with *A*’s banking system, the fraudulent resident exchanging it for an equivalent deposit with *B*’s banking system. This means that national monetary boundaries are a natural barrier against capital movements, which become entirely free only within a single monetary area.

Logically, even investment between countries does not modify the amount of capital initially available in each of them. Of course, the logical impossibility for capital to leave a country’s banking system does not mean that capitals cannot be *invested* from a country to another; in this sense, capital mobility would not be hampered. Let us suppose, for example, that residents of country *A* are willing to invest part of their capital in country *B*. If they do so, this does not mean that the amount of capital available in *A* is decreased by the amount invested in *B*, but only that country *B* is now the owner of a sum of bank deposits formed in *A*’s banking system. In the event that *A*’s residents invest by purchasing financial assets issued by *B*’s residents, country *A*’s investment amounts to its lending to *B* a capital in money *A* that *B* can spend to finance its imports from country *A*. Things are not radically different if *A*’s residents invest their capitals



simply by acquiring a deposit with  $B$ 's banking system, that is, by purchasing claims of various liquidity from the banks of country  $B$ . The capitals thus invested by  $A$ 's residents remain deposited in  $A$ 's banking system but they are now owned by  $B$ 's residents (while  $A$ 's residents become the owners of an equivalent sum of  $B$ 's bank deposits). Hence, by transferring their capitals to country  $B$ ,  $A$ 's residents actually convert them into an equivalent capital formed in  $B$ . Their investment does not reduce the amount of capital available in  $A$ , the whole amount of which is thus liable to be invested – either directly or indirectly – in this same country. If it is lent to firms in  $A$ , the investment is direct; if it is lent to country  $B$  it becomes part of  $B$ 's foreign transactions and finances its imports from country  $A$ , thus defining an indirect investment in  $A$ . In both cases, it is correct to claim that whatever the decision taken by  $A$ 's residents their financial transactions do not decrease the amount of capital that may be invested in  $A$ .

The same result applies also when a sum of domestic currency is entered as an asset into a foreign banking system. This happens, for example, when a key-currency country pays for its net commercial imports. The banking system of the creditor country is credited with a positive amount of key-currency that remains deposited within the debtor country. Already explained by Rueff in the 1960s, this phenomenon entails a duplication of the key currency, which does not alter in the least the amount deposited in its banking system. It is double-entry book-keeping that brings about this result, which will hold good as long as countries do not give up their monetary sovereignty.

By adhering to monetary unification, EU countries will de facto create a single area within which capitals will move as freely as they do within each national monetary system. It is precisely this free capital movement in the euro area that is likely to bring about the most serious troubles for the EU. It is a well-known fact that capitals move from the regions of lesser to those of higher productivity, which, in the last decades, means from South to North. This would mean that, in the euro area, capital will 'flee' from the southern to the northern part of Europe, thus increasing disparities among countries of the two 'regions'. In particular, it is not exaggerated to forecast that unemployment will grow dramatically in the region suffering from capital flight and that public transfers will prove insufficient to match its negative effects.

It is true, of course, that the financial structure of the capital accumulated so far by each country will play an important role in determining the way capital will move within the EU. For example, if the capital accumulated by firms of a given southern country in, say, the last ten years has been obtained by selling medium- to long-term bonds, monetary unification will put them at a disadvantage with respect to their northern competitors. The cost of capital accumulated in the southern countries is in fact higher than that accumulated in the northern countries. Disparities in the gross rate of profit and reduced costs of production have allowed southern firms to remain competitive so far. Monetary unification, however, will increase their current costs without reducing the cost of the capital accumulated prior to the introduction of the euro. In these conditions it is very likely that even firms of the most productive regions of the South will be forced to accelerate their restructuring process drastically. Mergers with northern firms

will probably increase and employment will be the first to suffer from the measures adopted in order to avoid closure.

This might be thought to be the very pessimistic scenario of a euro-sceptic. It is not. If the European unification project is to have a real chance of success, difficulties must be faced and discussed openly and not kept hidden from the public. If this is not done, Europeans could well refuse to pay the price of unification and force their countries to move back to monetary and political sovereignty. The question has to be tackled whether European countries can afford a drastic increase in capital movements. In other words, will there be an efficient network of adjustments capable to contrast its negative effects? The limited mobility of workers, the lack of fiscal redistribution mechanisms of some importance, and the structural rigidity of numerous economies would seem to deny it. If this is indeed the case, would it not be better to think again about giving up monetary sovereignty? The answer is closely related to the possibility to achieve monetary stability without adopting a common and unique currency. Is exchange rate stability a result that necessarily implies monetary unification? Apparently, yes. As we have seen, neither 'soft' nor 'hard' pegs are viable solutions, and free floating is, by definition, a system where exchange rates are essentially unstable. Yet, despite appearances to the contrary, a new structure of payments can be devised, which ensures the automatic stability of exchange rates between the countries adopting it, and which is perfectly euro-compatible. Let us expound the main principles on which it rests.

*Towards a new regime of stable exchange rates compatible with the safeguard of monetary sovereignty*

Today's exchange rate regimes belong to the category of relative exchanges, for currencies are considered as if they were real goods and exchange rates are defined as their relative prices, i.e. as the price of each of them expressed in terms of one or the other with which it is exchanged on the foreign exchange market. By close analogy with what is supposed to happen on the commodity market – at least according to the neoclassical point of view –, exchange rates are thus made to depend on supply and demand, and their determination becomes a matter of equilibrium. To avoid the instability inherent in every concept of equilibrium it is necessary to move from a regime in which exchange rates are identified with relative prices to a new regime in which currencies are no longer objects of trade *per se*, and exchange rate does not define the price of one currency in terms of another. Does such a claim sound strange to the modern reader? We think not. The oddity is rather that in the year 2001 there are still economists believing in the physical nature of money. Modern banking, e-money and speculative financial transactions are a clear proof of the substantial dematerialisation of money. How is it possible to claim that a simple, numerical means of exchange can be transformed into an object of exchange? If it is true, as shown by Rueff and definitively confirmed by double-entry book-keeping, that national

currencies may enter a foreign banking system only as mere duplicates, how can it be maintained that, once abroad, national currencies are transformed into a stock of autonomous monetary assets? But, if it is agreed that money is a non-dimensional means and not an object of exchange, it should be clear that our payment systems must be structured in such a way as to comply with the vehicular nature of money. This can be done if today's regime of relative exchange rates is replaced by a system of absolute exchange rates in which each currency is exchanged against itself (albeit through another one or through a common standard such as the euro).

Let us take the European example. The idea is that exchange rate stability can be achieved without replacing the national currencies of EU member countries with the euro. Yet, the euro will play an essential role in the new system, as will the European central bank (ECB). In order to avoid duplication as well as exchange rate fluctuations, transactions among EU countries and between them and the Rest of the World will have to be carried out in euros. It is the ECB that will be called upon to issue the euro according to the same principles of double-entry book-keeping adopted at the national level. As already observed by Keynes in his plan of reform presented at Bretton Woods in 1944, the necessary balance between liabilities and assets will be enough to prevent any problem of monetary liquidity. This means that double-entry book-keeping is all the ECB needs in order to provide the EU countries with the amount of vehicular euros required to monetise their external transactions. However, if we were to stop here, the system would not be viable, for it would leave us with the problem of how countries are to finance their unsettled transactions. It is again the ECB that must intervene by acting as a financial intermediary. What is required in order to give a real content to the payments in euro is a system of inter-European clearing. The principle is well known. Adopting a real-time gross settlement system, the ECB will carry out payments between member countries only if each of them provides for its financial backing. In simple terms, this means that a country must finance its net commercial imports by an equivalent amount of exports of goods, services or securities.

It is not difficult to show<sup>5</sup> that if external payments are carried out through the monetary and financial *intermediation* of the ECB, each national currency is instantaneously exchanged against itself through the euro. In other, more traditional words, each currency is simultaneously offered against and demanded by the euro, which obviously leaves its exchange rate unaltered. Together with the central banks of the member countries, the ECB is thus the key element of the new system. Thanks to them, European countries will be allowed to benefit from their monetary sovereignty until it proves necessary. In the meantime, they will create a common monetary area that, besides guaranteeing exchange rate stability, will provide a strong link among member countries, and make of the euro the European currency vis-à-vis the Rest of the World. Far from being a 'second best' solution, the new system will allow a better start to the process of European unification without hampering it with the negative consequences of the sudden loss of monetary sovereignty.

As already noted, the reform is based both on the vehicular use of the euro and on a system of inter-European clearing managed by the ECB. As such, it will allow co-operation among

member countries to be strengthened, particularly at the level of monetary and economic policies, yet at the pace and to the extent better suited to an harmonious process of economic and political convergence. Although the main purpose of the ECB will be that of providing EU member countries with an orderly payments system, nothing will prevent it from playing a more active role, both in order to promote new forms of co-operation among national central banks and to widen its field of intervention. For example, we may well imagine a scenario in which the ECB could intervene on the European financial markets to place its own securities. Through its active financial *intermediation*, less developed countries of the euro area – which could easily be extended to incorporate other European countries now on the EU waiting list – could thus find new resources, besides those invested directly by their fellow countries, to accelerate their economic recovery. Well managed, this instrument could prove extremely helpful in reducing today's discrepancies between rich and poor countries, thus reinforcing solidarity among EU countries.

Everybody knows how difficult it is to implement a mechanism of income redistribution through fiscal policy. Likewise, it is no mystery that public efforts to compensate for the lack of private investment have very rarely been successful. If EU countries were to lose their monetary sovereignty as planned, it is easy to imagine how difficult it would be to force a mechanism of fiscal redistribution upon residents of the northern regions, or to transfer public funds to the southern regions. If, instead, EU countries were to maintain their national currencies and adopt the new payments system proposed here, transfers would take place through the financial *intermediation* of the ECB. This means that, by selling its securities on the European financial markets, the ECB will collect private capitals and invest them in the countries most in need of them. Fiscal redistribution and public transfers would then be replaced by an investment of private capitals carried out by the ECB. Of course, the ECB financial activity would have to be rigorously supervised and would have to respect the principles of sound banking. If these obvious requirements are fulfilled, there are no reasons to believe that the ECB *intermediation* will not prove to be a much more efficient means of redistribution than any public mechanism (which would retain its importance only for social purposes and be autonomously implemented by each country).

As already mentioned, another advantage of the new regime of absolute exchange rates would be to greatly facilitate the extension of the euro area to other European countries. Since countries will no longer be asked to replace their national currencies with the euro and thus be transformed into regions of one sole new country, requirements for adhering to the new European system of payments will be easily met by would-be member countries. In fact, conditions for membership would be limited to one's commitment to comply with the rules of the system. Each new country applying for membership should simply be prepared to have its central bank collaborate with the ECB and adopt the euro and the European clearing system for the settlement of its external transactions. Hence, while the new system of external payments will allow each new member country to benefit from a regime of exchange rate stability, the collaboration with the ECB will favour the implementation of all the reforms needed to guarantee the orderly working

of their domestic monetary system. This is not to say that the ECB will exert any direct control whatsoever over any member country's monetary system. Let us repeat it with no room for ambiguity: each member country will retain its monetary sovereignty and will be free to choose the fiscal and monetary policies best suited to its needs. Yet, monetary sovereignty is not enough to guarantee monetary order. Collaboration with the ECB should precisely help less advanced countries to organise their banking system in such a way as to avoid any anomaly.

Let us also observe that the use of the euro as a means of international payment (both among European countries and between them and the Rest of the World) does not prevent European residents from using euro-banknotes for their payments. Domestic transactions would be settled in domestic currencies, but it would be neither unreal nor wrong to imagine that some of them may be settled by using euro-banknotes. Tourism is the most obvious example. German residents might well spend their holidays in Italy and pay for them in euro-banknotes obtained in exchange for marks. The ECB would still be involved in the operation, for it is through its *intermediation* that German banks can provide their clients with euro-banknotes, and that these same banknotes give Italy a credit in its clearing account. The euro-banknotes earned by Italian residents, in fact, are transferred to the ECB (through the intermediary of the Bank of Italy), where they are credited on the Italian clearing deposit. Not surprisingly, services sold to German tourists are part of Italy's exports and increase its capacity to import goods, services and securities from Germany (or from another EU country). If, for political reasons deriving from the symbolism conveyed by euro-banknotes, the use of European notes were encouraged, the new system would easily adjust to it, to everybody's satisfaction.

In conclusion, the passage from a regime of relative to one of absolute exchange rates would mark a radical change for the European monetary system. Without depriving EU countries of their national currencies, the new structure of payments will gather the different countries together in a common area where transactions among them will all be settled by the use of a common money: the euro. While protecting themselves from capital flight, EU countries will benefit from a mechanism guaranteeing exchange rate stability and will, in the meantime, create the sound premises for an increasing economic integration. This would be achieved, let us say it once again, through the monetary and financial *intermediation* of the ECB, and would invest the ECB with the tasks of creating the euro as a European vehicular money, managing the system of inter-European (gross) settlements, and providing extra investments to less developed countries.

The present structure of the ECB and of the Trans-European Automated Real-time Gross-settlement Express Transfer system (TARGET) will make it extremely easy to implement a regime of absolute exchange rates at the European level. What about the international level then? How may exchange rate stability be achieved world-wide?

*What future for the world?*

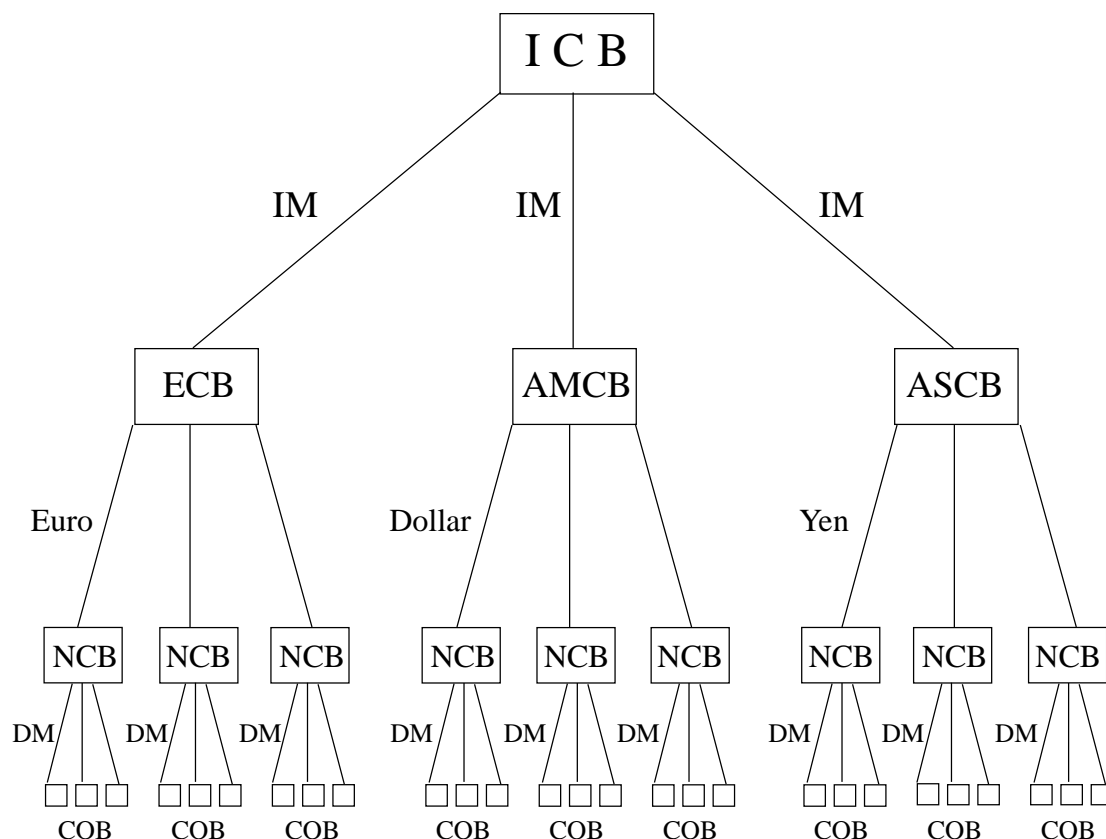
At the Economic Forum held at the IMF, November 8, 2000, the main item on the agenda concerned the possibility of transforming the world into a unique currency area. All the participants agreed on the unrealistic character of such a proposal if by world currency union it is meant the introduction of one single world currency. Do things change radically if – as Mundell does – we define a currency area as a zone of fixed exchange rates? Is it reasonable to suggest that all the countries of the world should enter a single currency area by fixing the exchange rates of their national currencies to a unique standard (a currency or a basket of currencies)? Certainly not if the model proposed were that of a currency board or of dollarisation. As we have shown in the first part of this paper, each of these solutions will seriously hamper economic development and will soon become untenable. A much better model would seem to be that of the euro area, where twelve national currencies are part of a system in which each of them may be exchanged against any other only at a fixed exchange rate. Yet, a fixed exchange rate system such as that momentarily adopted by the majority of EU countries may be viable only in the short term. If it is not rapidly replaced by monetary unification – which is precisely what these EU countries are committed to do –, destabilising pressures will unavoidably grow and lead countries to abandon the system in order to recover monetary sovereignty. If it is true, as Mundell observes, that fixed and irrevocable exchange rates are bound to completely abolish speculative capital movements, it is also certain that if the present structure of international payments is not modified, settlement of international transactions will go on increasing the amount of speculative capital available internationally. Irrevocably fixing exchange rates will thus not be enough to introduce monetary order world-wide. Besides, disparities among countries are so great, that it is foolish to believe that the conditions for the creation of a global currency area will be met in the foreseeable future.

Today, experts seem unanimous in forecasting the formation of two or three big currency areas in which all the existing national currencies might gradually converge. '[T]he advent of the euro and the move of a number of countries toward euro- or dollar-based pegs (possibly as a precursor to full monetary union or dollarization) indicates a trend movement toward a bi- or tri-polar system of major currency areas' (Mussa *et al* 2000: 36). Hence, while it is difficult to foresee the creation of other currency areas in the near future, the primacy of dollar, euro and yen seems sufficiently well established to make a tripolar system the most likely substitute for the present dollar-standard system. Now, the majority of experts seem to endorse the idea that a regime of floating exchange rates will be best suited to deal with fluctuations among the three major currencies than any pegged exchange rate regime. Given the great instability shown by these three currencies, the costs of managing a system of pegged exchange rates would be too high and its results too hazardous for it to be a viable alternative to free floating. It is generally believed, therefore, that exchange rates between dollar, euro and yen will continue to exhibit a high degree of volatility and that in order to limit their fluctuations monetary authorities will simply turn to an informal or loose system of co-ordinated foreign exchange market interventions.

In this respect, Mundell's is a voice out of the chorus. He claims, in fact, that a system of fixed exchange rates among the three major currency areas is perfectly conceivable today and would greatly benefit monetary stability<sup>6</sup>. According to Mundell, exchange rates between the dollar, the euro and the yen should be 'locked' replicating what was done in Europe in 1999. What he proposes is a three-currency monetary union in which speculative capital movements would be abolished by the simple fact that exchange rates would remain irrevocably fixed. As we have already noted, however, the decision of irrevocably fixing exchange rates is not enough to avoid the accumulation of international speculative capital. Duplication would still occur, and exchange rate stability itself would be continuously threatened by speculation. Transactions on the foreign exchange market, in fact, would put the three major currencies under a destabilising pressure, which, far from leading to an exchange rate fluctuation, would provoke disruptive variations in interest rates, inflation rates, employment, capital accumulation, and so on. The conditions required for the implementation of a currency area would no longer be fulfilled and a return to free or partially managed floating would be unavoidable.

Yet, Mundell's proposal deserves serious consideration. A system of stable exchange rates extended to the dollar, the euro and the yen would indeed mark a clear progress towards international monetary order. Now, the main obstacle to this end is the fact that today currencies are traded on the foreign exchange market and that exchange rates are their relative prices. As long as this is the case, any attempt to fix exchange rates is bound to failure. As we have seen in the euro case, true exchange rate stability can be achieved – without giving up monetary sovereignty – only by moving from the present regime of relative exchange rates to a new regime of absolute exchange rates. If this were done for the dollar, the euro and the yen their exchange rates would acquire a much greater stability, for they would no longer contribute to the increase of speculative capital. It is true, of course, that complete stability could be reached only if the currencies already present on the foreign exchange market were no longer objects of trade. But it is also true that once the principles of absolute exchange rates are correctly understood, the logic of monetary payments will point to the solution. More specifically, the new system will allow experts to work out a plan to avoid speculative trading on the foreign exchange market and to gradually reabsorb (for example, through a capital-equity programme) the speculative capital formed so far.

As for the three-currency area envisaged by Mundell, its realisation will require the institution of an international central bank responsible for issuing a currency that will become the common standard for dollar, euro and yen and that will be used to carry out payments among countries of the three currency areas. The new central bank will also have to act as a clearing agent in connection with the central banks of the three regions. What is needed for the whole system to work is therefore that (a) within each currency area payments among countries be carried out through the *intermediation* of their central banks and of a central bank of central banks, and that (b) between currency areas an international central bank act as the central bank of their central banks.



*Figure 1*

Figure 1 depicts the pyramidal structure of the new system. On the bottom line we find the commercial banks (COB) operating in each single country of the three-currency area. Their transactions are carried out in domestic currencies, for countries maintain their monetary sovereignty. The second line represents the national central banks (NCB). They act as clearing agents of commercial banks and guarantee national monetary homogeneity. At the third level we have the central banks of the euro, dollar and yen currency areas. They guarantee monetary homogeneity in each area through the emission of a monetary standard used as vehicular currency by member countries in all of their reciprocal payments. They also provide a mechanism for the financial settlement of transactions by operating a system of clearing in collaboration with national central banks. Then, at the top of our figure, we have represented the international central bank (ICB), which brings the European central bank (ECB), the American central bank (AMCB) and the Asian central bank (ASCB) together into a system of international clearing based, like the national clearings, on the principles of real-time gross-settlement transfers. Finally, DM stands for the domestic money used in each country; the euro, the dollar and the yen are the currencies used within each currency area when payments between member countries are concerned; and the international money (IM) is the new means of payment used to vehiculate transactions among the three-currency area members and between them and the Rest of the World.



### *Conclusion*

In Appendix IV of the IMF Occasional paper No. 193 devoted to exchange rate regimes in an increasingly integrated world, we read: ‘it must be recognized that while so far economic science has developed a number of criteria that seem relevant for the choice of exchange rate regime, there is no agreement on how precisely to quantify the various criteria or, to the extent that they conflict, on how to decide which should take priority’ (Mussa *et al* 2000: 48). This is indeed the present state of the art as far as exchange rate regimes are concerned. We maintain that the main cause of most economists’ uncertainty and disagreement is the lack of distinction between relative and absolute exchange rates. In particular, a clear step forward towards monetary stability will be achieved when payments are carried out without entailing any duplication, that is, respecting the vehicular nature of money. The European attempt to create a common monetary area is of a great interest, for it goes a long way in the right direction. If it failed, it would be a disaster that would weigh heavily on all those people who believe in European integration and in monetary stability. This is why it is necessary to face and thoroughly analyse all the problems related to monetary unification. The loss of monetary sovereignty to which the adoption of the euro as a unique currency will lead has arguably been underestimated in its negative consequences on capital movements. Given the past and present economic situation of EU member countries, monetary unification will be a great threat to employment in the South and a cause of increasing social turmoil in the North. These should be good enough reasons to push ECB’s experts to look afresh at the role of the euro. As recent analysis shows, in fact, the very objective of monetary unification – exchange rate stability – may be reached while allowing countries to maintain their sovereignty.

In this short essay we have summed up the principles on which the new European payments system should rest. Our aim is mainly to raise the reader’s interest in a reform that could rapidly and easily be enforced at the EU level. The necessary institutions are already in place, and the ECB could well take on the task of devising for Europe a sound and stable payments system between sovereign countries. Let us hope that European experts will not immolate scientific analysis on the altar of politics, and that they will follow Schmitt’s example in a joint effort to give Europe and the world a real chance to achieve monetary stability.

If ‘impossible’ lives in Utopia, it is certainly not utopian to suppose that, once achieved, scientific progress may take hold of people’s mind, especially if the well-being of whole populations depends on it. In our field, advancement of learning is threefold. Bank money is a *means* of payment and not a net *asset* (bank money is an object of *mediation* and not a *final* product); European monetary union requires the creation of a common currency of European *countries* and not a single currency for their residents. Finally, the European central bank will issue a *basket of currencies*, i. e. [the euro] as it is already defined today.

(Schmitt 1988: 173, our translation)

*Notes*

<sup>1</sup> See Quaderno di ricerca No. 2 in this series.

<sup>2</sup> With the exception of Denmark, United Kingdom and Sweden.

<sup>3</sup> The correct functioning of a banking system, in fact, does not allow for any gain of seigniorage. As every banker knows, banks do not create wealth or riches when issuing money. Thus, allowing banks to derive a seigniorage from money creation simply amounts to an inflationary emission that has no citizenship in an orderly monetary system.

<sup>4</sup> Calvo and Reinhart (2000), Eichengreen and Hausmann (1999).

<sup>5</sup> See Cencini and Schmitt (1992).

<sup>6</sup> See Mundell *et al* (2000).

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